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BEFORE THE ARIZONA CORPORATION COMMISSION

JAM A. MUNDELL
CHAIRMAN

JIM IRVIN
COMMISSIONER
MARC SPITZER
COMMISSIONER

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IN THE MATTER OF THE APPLICATION OF
ARIZONA PUBLIC SERVICE COMPANY FOR AN
ORDER OR ORDERS AUTHORIZING IT TO ISSUE,
INCUR, OR ASSUME EVIDENCES OF LONG-TERM
INDEBTEDNESS; TO ACQUIRE A FINANCIAL
INTEREST OR INTERESTS IN AN AFFILIATE OR
AFFILIATES; TO LEND MONEY TO AN AFFILIATE
OR AFFILIATES; AND TO GUARANTEE THE
OBLIGATIONS OF AN AFFILIATE OR AFFILIATES

AZ CORP COMMISSION
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NOTICE OF FILING

Pursuant to the Procedural Order dated October 9, 2002, the Arizona Utility Investors Association hereby provides notice of filing the direct testimony of Walter W. Meek in the above captioned proceeding.

Respectfully submitted, this 13th day of December, 2002.

Walter W. Meek

Walter W. Meek, President

Arizona Corporation Commission
DOCKETED

DEC 13 2002



CERTIFICATE OF SERVICE

An original and ten copies
of the referenced testimony
were filed this 13th day of
December, 2002, with:

Docket Control
Arizona Corporation Commission
1200 W. Washington Street
Phoenix, AZ 85007

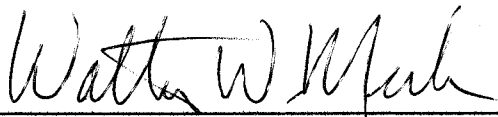
Copies of the referenced testimony
were delivered this 13th day of
December, 2002, to:

Hercules Dellas, Esq., Commissioner Wing
Kevin Barlay, Esq., Commissioner Wing
Paul Walker, Esq., Commissioner Wing
Christopher Kempley, Esq., Legal Division
Lyn Farmer, Esq., Hearing Division
Ernest Johnson, Esq., Utilities Division
Arizona Corporation Commission
1200 W. Washington Street
Phoenix, AZ 85007

A copy of the referenced testimony mailed
this 13th day of December, 2002, to:

Thomas L. Mumaw, Esq.
Pinnacle West Capital Corporation
P.O. Box 52132
Phoenix, AZ 85072-2132

All Parties of Record

A handwritten signature in cursive script, appearing to read "Walter W. Meek", is written over a horizontal line.

Walter W. Meek

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2
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6
7
DIRECT TESTIMONY

OF

WALTER W. MEEK

8 Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

9 A. My name is Walter W. Meek. My business address is 2100 North Central
10 Avenue, Suite 210, Phoenix, Arizona 85004.

11
12 Q. BY WHOM ARE YOU EMPLOYED AND IN WHAT CAPACITY?

13 A. I am the president of the Arizona Utility Investors Association ("AUIA" or
14 "Association"), a non-profit organization formed to represent the interests
15 of shareholders and bondholders who are invested in utility companies that
16 are based in or do business in the state of Arizona.

17
18 Q. ARE SOME AUIA MEMBERS SHAREHOLDERS OF PINNACLE WEST
19 CAPITAL CORPORATION?

20 A. Yes. AUIA has approximately 6,000 members and a substantial percentage
21 are common shareholders of Pinnacle West Capital Corporation
22 ("PWCC"), the corporate parent of Arizona Public Service Company
23 ("APS").

24
25 Q. WHAT IS YOUR BACKGROUND IN REPRESENTING SHAREHOLDER
26 CONCERNS AND INTERESTS?

27 A. I have been president of AUIA for more than eight years. Prior to that, my
28 consulting firm managed the affairs of the Pinnacle West Shareholders
29 Association for 13 years. During this time we have represented
30 shareholders in numerous rate cases and other regulatory matters and
31 have published many position papers, newsletters and other documents in
32 support of shareholder interests.
33

1 Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

2 A. I am here to represent the views of the equity owners of PWCC regarding
3 APS's request for authority to extend its credit to assure permanent
4 financing for the Redhawk and West Phoenix power plants built by
5 Pinnacle West Energy Corporation (PWEC).
6

7 Q. HOW WOULD THIS OCCUR?

8 A. As I understand it, APS wants the flexibility to loan up to \$500 million or
9 provide a corporate guarantee to PWCC or PWEC in support of a
10 permanent financing plan to replace a majority of the bridge financing
11 Pinnacle West currently has in place.
12

13 Q. WHAT IS AULA'S POSITION?

14 A. We urge the Commission to grant APS the authority it seeks. We are
15 convinced that this action would be in the public interest in safeguarding
16 the financial integrity of APS and its parent. The alternatives to this course
17 of action would be damaging to the entire Pinnacle West group of
18 companies and to APS's customers.
19

20 Q. DO THESE POWER PLANTS SERVE APS CUSTOMERS?

21 A. Yes, they do.
22

23 Q. ARE THEY OWNED AND OPERATED BY APS?

24 A. No. They are owned and operated by PWEC, a Pinnacle West subsidiary.
25

26 Q. ARE THESE PLANTS SUBJECT TO COST-OF-SERVICE REGULATION BY
27 THE CORPORATION COMMISSION?

28 A. No, they are not.
29

30 Q. WHY SHOULD THE COMMISSION BE CONCERNED ABOUT HOW THEY
31 ARE FINANCED?

32 A. As the testimony of company witness Barbara Gomez indicates, Pinnacle
33 West is on the brink of serious financial difficulties due to recent regulatory
34 decisions affecting those power plants.

1 In our opinion, if Pinnacle West is punished in the financial markets, the
2 impact will spill over onto APS and affect its ability to raise capital at a
3 reasonable cost. Clearly, that could affect the cost and quality of customer
4 service.

5
6 Q. IS THE COMMISSION AT FAULT FOR THIS SITUATION?

7 A. Blame should not be the issue here. However, we can't ignore the
8 sequence of events that led to this dilemma.

9
10 Q. WHAT WERE THOSE EVENTS?

11 A. I don't want to belabor history, but the short version is this:
12 When the Commission adopted the electric competition rules in 1999, they
13 included a directive to the utilities to divest all of their generation assets to
14 one or more affiliated companies by the end of 2002. PWEC was formed
15 for that purpose, to be the repository for APS's divested generation
16 portfolio and long term supply contracts.

17 However, the Commission also made the utilities the providers of last
18 resort, with the responsibility of providing their customers with reliable
19 energy at an acceptable cost, regardless of divestiture.

20 When APS's forecasts showed the need for increased resources, the
21 company concluded it was more prudent to build new generation, both
22 inside and outside the Phoenix load pocket, than to rely entirely on
23 wholesale purchases.

24 In anticipation of divestiture, Pinnacle West built and financed the plants
25 within PWEC rather than in APS. In addition, the APS code of conduct,
26 which was required by the electric competition rules, forbade the utility
27 from engaging in competitive activity, which clearly applies to new
28 generation.

29 PWEC had no appreciable assets, but an investment grade interim financing
30 program was negotiated utilizing Pinnacle West's credit rating. Permanent
31 financing at investment grade level was dependent on the transfer of APS's
32 generating portfolio to PWEC.

1 Last Sept. 10, in Decision No. 65154, the Commission reversed course on
2 divestiture, requiring the utilities to continue serving their customers with
3 the generation that they own. That left the PWEC power plants in limbo,
4 owned by an affiliate without permanent financing and with no access to
5 credit.

6
7 Q. WAS IT A PRUDENT DECISION TO BUILD THESE FACILITIES?

8 A. Absolutely. In June 2000, when construction began on combined cycle Unit
9 4 at West Phoenix, the western electricity markets were beginning to come
10 apart at the seams. Given the choice, a prudent utility manager would have
11 preferred to own the sources of his incremental needs going forward than
12 to rely on the wholesale market.

13
14 Q. WHAT IS THE MAGNITUDE OF PINNACLE WEST'S FINANCIAL
15 EXPOSURE?

16 A. According to Ms. Gomez, Pinnacle West will be on the hook for about \$765
17 million of PWEC investment by the middle of next year. At that time, the
18 majority of the interim loans also will start coming due.

19
20 Q. WHAT PREVENTS THE COMPANIES FROM REFINANCING AT THE
21 HOLDING COMPANY LEVEL?

22 A. It appears that without APS's participation, Pinnacle West simply doesn't
23 have the asset base to support that much debt and PWEC reportedly has no
24 access to credit at all. At a minimum, if PWCC could sustain this debt, it
25 would take a serious and probably unacceptable hit to its financing costs
26 and APS, as the chief underlying source of cash resources, would also be
27 penalized in the financial markets.

28
29 Q. WHAT IF APS'S REQUEST IS DENIED?

30 A. The APS proposal is a reasonable attempt to rectify a very messy situation.
31 The rating agencies have sent clear signals that more credit downgrades are
32 in store for Pinnacle West and APS if the financing impasse isn't resolved in
33 an acceptable manner. However, the consequences could go further than
34 that.

1
2 Q. WHAT ARE THE OTHER CONSEQUENCES?

3 A. If APS's credit can't be utilized, we think it is not inconceivable that a
4 bankruptcy and/or a forced sale of some or all of the PWEC assets could
5 occur. Of course, any sale in the near future would be into a market that is
6 already glutted with the bad construction decisions of merchant generators.
7

8 Q. WHAT WOULD BE THE IMPACT ON APS?

9 A. That is hard to predict, but it wouldn't be positive. These days, it is
10 increasingly difficult to insulate an affiliate from the fortunes of its holding
11 company and vice versa and it is unrealistic to expect that APS would be
12 immune from a financial meltdown at Pinnacle West.
13

14 Q. WHAT ARE THE RISKS OF THE FINANCING PROPOSAL TO APS AND
15 ITS CUSTOMERS?

16 A. There are no apparent risks. Ms. Gomez asserts that APS has plenty of
17 credit headroom to handle a loan or guarantee to its affiliates without risk
18 to its own credit and we have no reason to doubt her evaluation. Also, the
19 plan would shield utility customers from any financing costs incurred by
20 APS.
21

22 Q. WHAT IF A DEFAULT OCCURRED?

23 A. It could depend on the precise terms of the credit plan in place, but it's
24 conceivable that APS could become the owner of a few generating units
25 that have not been deemed to be used and useful. It wouldn't be the first
26 time, as any veteran of the Palo Verde rate basing can attest. It would
27 certainly be preferable to the consequences I discussed previously.
28

29 Q. WHAT WOULD APS DO WITH THE PWEC PLANTS?

30 A. Again, that's hard to predict. It would depend on conditions at the time.
31 Obviously, APS could seek permission to include them in its regulated rate
32 base. If a default were far enough down the road, divestiture might be
33 back in play. We don't discount entirely the possibility that Pinnacle West

1 might want to dispose of some of the PWEC units someday, but ideally, not
2 until the market has absorbed some excess capacity.

3
4 Q. HOW COULD APS OWN AND OPERATE COMPETITIVE GENERATION
5 IN A WHOLESALE BIDDING ENVIRONMENT?

6 A. It's doubtful that APS would attempt that. They could assign the PWEC
7 units to another affiliate, which could bid their output, either at arm's length
8 or in a blind bidding process like that proposed by company witness
9 Thomas Carlson in the Track B proceeding.

10
11 Q. CAN PINNACLE WEST ISSUE STOCK TO PAY OFF THE PWEC DEBT?

12 A. It probably can, but that would be a poor decision if there were any other
13 viable options.

14
15 Q. WHY WOULD THAT BE A BAD STRATEGY?

16 A. There are several reasons. First, it is probably the most costly option.
17 Common equity is the most expensive component of a utility's capital
18 structure and has a direct impact on revenue requirements from
19 ratepayers.

20 Second, the price of Pinnacle West's common stock has been hovering at or
21 below book value, 40 percent off of its 52-week high. It is not a good
22 strategy to issue stock when the price is low because you have to sell too
23 many shares to achieve your revenue goal and you inflict too much dilution
24 on existing shareholders.

25 Third, the strategy might backfire if Pinnacle West issued stock without
26 fixing the PWEC credit problem first. If PWEC were left unattended, Wall
27 Street would have to view the stock issue as an investment in merchant
28 generation, which at this time would not be well received.

29 For all of these reasons, a stock issue should be the very last resort.

30
31 Q. YOU MENTIONED MERCHANT GENERATORS. DO THEY HAVE A
32 PLACE IN THIS PROCEEDING?

33 A. As far as AUIA is concerned, this is a matter between a regulated Arizona
34 utility and its regulators. The merchants are essentially carpetbaggers and

1 they have no legitimate interest in this proceeding, but it's clear that they
2 will be in evidence.

3
4 Q. WHAT DO YOU ANTICIPATE THEIR POSITION WILL BE?

5 A. They have certainly shown their cards in other proceedings. It is probable
6 that they will urge the Commission to deny the financing application. As
7 an alternative, they are likely to implore the Commission to adopt a list of
8 onerous conditions like those advocated by Panda-Gila River for APS's
9 emergency financing on Nov. 22.

10
11 Q. WHY WOULD THE MERCHANTS OPPOSE THIS APPLICATION?

12 A. They have had a tendency to talk about reducing the risk to ratepayers, but
13 of course, they don't have any ratepayers. Nor will they, since the
14 merchants are exempt wholesale generators that have no retail customers.

15
16 Q. DO THEY HAVE OTHER REASONS FOR OPPOSING THE APPLICATION?

17 A. It's obvious that they regard PWEC as competition, not only for APS's
18 contestable load, but for electric loads throughout the west. They don't
19 want PWEC to receive investment grade financing because it might provide
20 PWEC with a competitive edge. Since most of the merchant generators no
21 longer enjoy high credit ratings, they want PWEC to join them in the credit
22 cellar.

23
24 Q. ISN'T IT FAIR FOR ALL UNREGULATED GENERATORS TO BE TREATED
25 ALIKE?

26 A. Not in this case. There are significant differences in the circumstances of the
27 merchant generators and that of PWEC, which the Commission should
28 recognize.

29
30 Q. WHAT ARE THEY?

31 A. First, the Redhawk and West Phoenix plants were built to serve APS
32 customers and they are doing that now. If Redhawk, for example, had
33 been built to serve other markets, PWEC would have sold its output into
34 the California forward market rather than reserving it to meet Arizona

1 needs. The merchant plants were planned to serve electric loads wherever
2 they can find them, especially in California.

3 Second, the PWEC plants were built by an affiliate of APS, which has a
4 continuing obligation to serve and to act as the provider of last resort to its
5 customers. The merchants have no obligation to anyone in Arizona.

6 Third, every decision that led to the current financial crisis facing Pinnacle
7 West and PWEC was made in the context of or in direct response to an
8 order of the Commission.

9
10 Q. DO YOU HAVE A CONCLUDING STATEMENT?

11 A. For all of the reasons we have cited, including the well being of APS's
12 customers, it is in the public interest for the Commission to rectify this
13 situation by granting the financing application.

14
15 Q. DOES THAT END YOUR TESTIMONY?

16 A. Yes, it does.
17
18